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Supreme Court, U.S.
FILED
MAR 16 1987
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

Case Number: _____

1986 Term

Standard Manufacturing Co., Inc.

Petitioner-Appellant,

-against-

Tax Commission of the State of New York and Roderick G. W. Chu, Francis R. Koenig and Mark Friedlander, acting as the Tax Commission of the State of New York,

Respondents.

On Appeal from the Court of Appeals
of the State of New York

Jurisdictional Statement

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41PP

IN THE

Supreme Court of the United States

STANDARD MANUFACTURING CO., INC.

Appellant

-against-

TAX COMMISSION OF THE STATE OF NEW YORK and RODERICK G. W. CHU, FRANCIS R. KOENIG and MARK FRIEDLANDER, acting as the Tax Commission of the State of New York,

JURISDICTIONAL STATEMENT

Respondents.

1. (a) The question presented is whether New York State Tax Law, Section 211(4), as it reads and/or as it is applied by the State, is in conflict with Section 936 of the Internal Revenue Code (26 USC 936), and is thus violative of the Supremacy Clause, the Due Process Clause and/or the Equal Protection Clause of the United States Constitution.

Appellant is a New York corporation with a principal place of doing business in New York State.

The State Tax Law permits New York to include for state taxation purposes the income of appellant's subsidiary, Caribbean Outerwear Corporation, which is located in Puerto Rico.

However, that income of Caribbean that is left undistributed in Puerto Rico receives Congressional protection under 26 USC 936 from taxation. The legislative intent of the Federal statute is to foster the economy of that Commonwealth - (Puerto Rico is considered a United States possession or territory for the purposes of the Federal statute, see 26 USC 936(d)(1)) - by making it desirable for corporations in the continental United States to open and maintain subsidiaries in Puerto Rico so that Puerto Rico might be economically competitive with foreign countries.

For many years New York State had not required Standard to file a combined report including Caribbean's income therein because New York does not consider income which is designated "exemption" as income for State tax purposes.

In 1976 Congress changed the format of the Federal protection of the "936" corporations' income from an exemption to a credit. The express purpose of this change was to further assure that parent corporations would be reluctant to remove their subsidiaries' income from Puerto Rico.

When the form of the protection changed from an exemption to a credit, New York State began to require the filing of combined reports on the basis that the State considers income which was designated "credit" as income for State tax purposes.

The State tax assessed against Standard was thus significantly increased. Standard contends that the State's actions are in conflict with the intent of the Federal law, as the incentive to open and/or to maintain a subsidiary corporation in Puerto Rico is now greatly reduced with the financial burden of the State tax. The larger, cumulative impact on other larger parent corporations with businesses in many states is obvious.

A further question presented is whether the State's invocation in 1976 of the requirement of a combined report, based solely as it was on the change in format of the Federal protection, is arbitrary and therefore in violation of due process and/or equal protection.

(b) The parties to the proceeding are Standard Manufacturing Co., Inc., Appellant, whose subsidiaries are:

Caribbean Outerwear Corporation - Puerto Rico
Logan Manufacturing Co. - West Virginia
Standard Leasing of Troy - New York
750 Management Corp. - New York

— and the Tax Commission of the State of New York, with Roderick G. W. Chu, Francis R. Koenig and Mark Friedlander, acting as the Tax Commission.

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(d) Reports of opinions below include:

- Decision of the New York State Tax Commission, dated May 2, 1984;
- Decision of the New York State Supreme Court, Appellate Division, 114 AD2d 138, Third Department, 498 NYS2d 724, 1986;
- Decision of the New York State Court of Appeals, 69 NY2d 635,_____NYS2d_____, 1987, which adopts the decision of the Appellate Division.

(e) Jurisdiction is invoked because the highest court of the State of New York has upheld a State statute which is in conflict with, and which frustrates, the intent of Internal Revenue Code, 26 USC 936.

(i) This is an appeal from a judgment of the New York State Court of Appeals, that State's highest court.

(ii) The judgment of the New York State Court of Appeals was entered on December 16, 1986. The Notice of Appeal with proof of service was filed on March 4, 1987 in the New York State Court of Appeals.

(iii) Jurisdiction is conferred by 28 USCA 1257 (2) and (3).

(f) "The Congress shall have power to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States; and nothing in this Constitution shall be so construed as to prejudice any claims of the United States or of any particular State." U.S. Const., Article IV, Section 3 c1.2.

All persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of laws.

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding. U.S. Const., Art. VI, c1.2

See 26 USC 931, 26 USC 936 and New York State Tax Law 211 (4) in appendix:

(g) In 1956 Congress deemed it necessary to make the Territory of Puerto Rico economically competitive with foreign nations. Congress perceived that Puerto Rico was burdened with many requirements (e.g. minimum wage, etc.) which were not hampering foreign nations. That year the Congress enacted Section 931 of the Internal Revenue Code (26 USC 931) which provided a tax exemption for the income of certain qualified subsidiary corporations if that income were left unrepatriated in Puerto Rico by the parent corporate taxpayer.

In 1976 and for the sole reason to further encourage the parent corporate taxpayers to leave the subsidiaries' income in Puerto Rico, Congress enacted 26 USC 936, changing the format of the Federal protection from a tax exemption to a tax credit. At this point, New York State began to require Standard to include for State taxation purposes the income of Caribbean in a combined report, arguing that "tax credit" income was income susceptible to State taxation.

Standard contended both in the Appellate Division and the Court of Appeals, by brief and by oral argument, that the requirement of a combined report frustrated the intent of the Federal Law by imposing an additional, unexpected and unforeseen financial burden on the parent corporate taxpayer which served to adversely affect the taxpayer's decision to continue its subsidiary in Puerto Rico, and/or to begin new subsidiaries in Puerto Rico.

In both Courts, in brief and in oral argument, Standard contended that the New York State Tax Law is in conflict with the Supremacy Clause of the United States Constitution, to the extent that that law serves to frustrate the intent of Federal Law, 26 USC 936, by reducing the incentive to have parent corporations open and maintain subsidiaries in Puerto Rico. The larger impact on corporations with businesses in many states is obvious. The overall result, it is argued, is to lessen, not improve, the competitive position of Puerto Rico vis-a-vis foreign countries.

The Court of Appeals adopted the decision of the Appellate Division which stated:

(1) that Standard failed to demonstrate that the State Law was in conflict with the Federal Legislation, (2) that Standard failed to demonstrate that preemption was the clear and manifest purpose

of Congress, (3) that the historic police powers of the states were not to be superseded by a Federal act unless such was the clear and manifest purpose of Congress, and (4) that there was no evidence of a Federal policy for preemption of state franchise taxes with respect to companies with businesses in Puerto Rico.

In both Courts, in brief and in oral argument, Standard further contended that the operation of the State Tax Law, beginning in 1976 for no reason other than the change of the form of the protection, was arbitrary, depriving that taxpayer of due process and/or equal protection. The decision below determined there was no violation of due process.

(h) Should New York State (or any or all of the 50 states), be allowed to require combined reporting for its resident parent corporations with "936" subsidiaries, the effect will be to impose a significant financial disincentive on the parent corporations, which disincentive was not contemplated nor desired by Congress. The effect of the states' taxation based on combined reports which include the income of "936" corporations, is to eviscerate the intent of the Federal Law by making it less desirous for resident parent corporations to invest in Puerto Rico.

A corporate taxpayer with businesses in many, (or all 50), states, which also has a "936" subsidiary, would undoubtedly find the cumulative taxations of the states an unacceptable burden vis-a-vis the subsidiary operation in Puerto Rico. The economic development of possessions of the United States is exclusively a Federal concern. (U.S. Const., Article VI, c1.2) Those state laws which adversely affect the intent of Federal laws are violative of the Supremacy Clause of the United States Constitution.

While the United States Supreme Court in *Container Corp. of America vs. Franchise Tax Board*, 463 US 159 (1983) specifically did not address the question of whether a state tax statute could be preempted by a Federal tax statute, state tax statutes were held to be violative of the Supremacy Clause in *Ramhah Navaho School Bd., Inc. v. Bureau of Revenue of New Mexico* 458 US 832 (1982), and *Maryland v. Louisiana*, 451 US 275 (1981).

The states will continue to adversely affect parent corporate decisions to invest in, and/or to continue to invest in, Puerto Rico, until the United States Supreme Court determines that the states may not require the income of "936" corporations to be included in combined reports of the parents for state taxation purposes.

In short summary, 26 USC §936 preempts the operation and effect of New York State Tax Law, §211(4)

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Remittitur

Court of Appeals
State of New York

The Hon. Sol. Wachtler, Chief Judge, Presiding

3 No. 441
In the Matter of Standard
Manufacturing Co., Inc.,

Appellant,

v.

The Commission of the State of New York, et al.,

Respondents.

Judgment Entered
12/16/86

The appellant(s) in the above entitled appeal appeared by Lombardi, Reinhard, Walsh and Harrison, P.C.

the respondent(s) appeared by Hon. Robert Abrams, Attorney General of the State of New York.

The Court, after due deliberation, orders and adjudges that the judgment is affirmed, with costs, for the reasons stated in the opinion by Justice Robert G. Main at the Appellate Division (114 AD2d 138; see also *Matter of Wurlitzer Company* v. *State Tax Commission*, 35 NY2d 100; *Matter of Campbell Sales Company* v. *New York State Tax Commission*, 68 NY2d 617). Chief Judge Wachtler and Judges Meyer, Simons, Kaye, Alexander, Titone and Hancock concur.

The Court further orders that the papers required to be filed and this record of the proceedings in this Court be remitted to the Supreme Court, Albany County

there to be proceeded upon according to law.

I certify that the preceding contains a correct record of the proceedings in this appeal in the Court of Appeals and that the papers required to be filed are attached.

Donald M. Sheraw, Clerk of the Court

Court of Appeals, Clerk's Office, Albany, December 16, 1986.

OPINION OF COURT
Supreme Court—Appellate Division
Third Judicial Department

January 30, 1986 50676

In the Matter of STANDARD MANUFACTURING COMPANY, INC.,

Petitioner,

v **OPINION**

TAX COMMISSION OF THE STATE OF NEW YORK et al.,

Respondents.

Argued, December 18, 1985.

Before:

HON. A. FRANKLIN MAHONEY,

Presiding Justice,

HON. ROBERT G. MAIN,
HON. ANN T. MIKOLL,
HON. PAUL J. YESAWICH, JR.,
HON. NORMAN L. HARVEY,

Associate Justices.

PROCEEDING pursuant to CPLR article 78 (transferred to the Appellate Division of the Supreme Court in the Third Judicial Department by order of the Supreme Court at Special Term, entered in Albany County) to review a determination of respondent State Tax Commission which sustained a franchise tax assessment imposed under Tax Law article 9-A.

LOMBARDI, REINHARD, WALSH & HARRISON, P.C. (Anthony J. Amodeo, Jr. of counsel), 433 State Street, P.O. Box 1053, Schenectady, New York 12301, for petitioner.

ROBERT ABRAMS, Attorney-General (Francis V. Dow of counsel), The Capitol, Albany, New York 12224, for respondents.

MAIN, J.

Petitioner, Standard Manufacturing Company, Inc. (Standard), is a New York corporation with its principal place of business located in the City of Troy, Rensselaer County, and is engaged in the manufacture, purchase and sale of outerwear clothing. Its wholly-owned subsidiary, Caribbean Outerwear Corporation (Caribbean), is a Delaware Corporation but has its principal place of business in Jabuyoa, Puerto Rico. Caribbean is primarily engaged in the manufacture and sale of "activewear", designed for wear by a person while engaged in somewhat strenuous physical exercise. George H. Arakelian, John Arakelian and Dorothy King own all of the outstanding shares of the common and preferred stock of Standard, are officers of both Standard and Caribbean and constitute the board of directors of each corporation. Sixto Gonzalez serves as chief executive officer of Caribbean and, although he reports annually to the board of directors, has almost unlimited authority

in the management of the corporation. During the years in issue, Caribbean sold 90% of its output to Standard. Caribbean's advertising was minimal, consisting of but two listings in local directories. Each of the corporations had its own legal counsel and accountant. Caribbean had its own independent line of credit with a Puerto Rican bank and hand no business, inventory or bank accounts in New York. A large percentage of Caribbean's profits remain undistributed in Puerto Rico in order to take advantage of the benefits of the Puerto Rican and possession tax credit (26 USC § 936).

The Audit Division of the State Department of Taxation and Finance issued notices of deficiency to Standard for the fiscal years ending July 31, 1978 and July 31, 1979 as a result of its failure to file a franchise tax report for Caribbean and to include Caribbean on its combined report. Upon Standard's filing for redetermination, a hearing was held at which George Arakelian, Standard's and Caribbean's president, testified, as did the chief executive officer of Caribbean. By decision dated May 2, 1984, respondent State Tax Commission denied the petition and sustained the notices of deficiency after finding that there were substantial intercorporate transactions between Standard and Caribbean and that the two corporations were part of the same unitary business. Standard then commenced this CPLR article 78 proceeding seeking to annul the determination.

The assessment of a franchise tax is a payment for the privilege of doing business in this State (Tax Law § 209 [1]). The payment is made on the basis of the "entire net income" as that term is defined in Tax Law § 208 (9). Under Tax Law § 211 (4), a taxpayer which owns or controls substantially all of the capital stock of another corporation may be required to submit a franchise report covering that other corporation if such a report is necessary to properly reflect the taxpayer's tax liability. Its purpose is to avoid distortion of and more realistically portray the true income of closely related businesses (*Matter of Coleco Inds.* v *State Tax Comm.*, 92 AD2d 1008, 1009, *affd* 59 NY2d 994). The then-applicable regulations under the section provide that the Tax Commission may require a combined report if the statutory requirement of ownership or control is met, the companies are engaged in a unitary business and there are substantial intercorporate transactions (20 NYCRR 6-2.1 [eff Jan. 1, 1976]).

Standard does not here challenge the ownership/control issue but asserts that the Tax Commission erred in finding that there was a unitary business and substantial intercorporate activity. We disagree. Caribbean sells 90% of its production to Standard, which, in turn, sells the garments to its customers. Caribbean expends little, if any, effort to sell its products to anyone else. While Caribbean's chief executive officer appears to have a free hand in the management of the corporation, he still remains accountable to Caribbean's board of directors and officers, all of whom hold the identical positions with Standard and collectively own all of the stock of Standard. In a matter such as this, which requires the analysis of a regulation applied to a particular factual situation, the administrative determination must be respected absent irrationality (*see, Matter of Howard* v *Wyman*, 28 NY2d 434, 438; *Matter of New York Life Ins. Co.* v *State Tax Comm.*, 80 AD2d 675, 676, *affd* 55 NY2d 758). If there are any facts or reasonable inferences to be drawn therefrom to support the Tax Commission's determination, it must be confirmed (*Matter of Levin* v *Gallman*, 42 NY2d 32, 34). The undisputed facts referred to above provide ample evidence to support the Tax Commission's conclusion that Standard and Caribbean were engaged in a unitary business and had substantial intercorporate transactions. Given the centralized management, large percentage of intercorporate sales and the meager attempts to sell elsewhere, such a conclusion can hardly be deemed irrational.

Having so concluded, we turn next to the ultimate question of whether, under all of the circumstances of the intercompany relationship in this case, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income. In answering this question, no single factor is decisive (*Matter of Coleco Inds.* v *State Tax Comm., supra*, p 1009). Here, in the view of the substantial extent and nature of the intercorporate transactions between Standard and Caribbean, we conclude that combined reporting would, in this case, result in a more realistic portrayal of true income, thus avoiding any distortion. Both Standard's assertion that is has shown that distortion was impossible, since Standard and Caribbean had entered into an agreement with the Internal Revenue Service to adjust their prices to reflect "arms length" transactions (*see*, 26 USC § 482), and the Tax Commission's assertion that this same agreement constitutes proof that there was in fact distortion, are flawed since there is no proof that price

adjustments pursuant to the agreement were made for the years in issue. Clearly, there is sufficient evidence to support the Tax Commission's determination that a combined report should be filed, and this determination must be upheld.

Standard further contends that requiring it to file a combined tax return is unconstitutional on two grounds: first, that it is preempted by the supremacy clause (US Const, art VI, § 2), and second, that it violates the due process clause (US Const, 14th amend, § 1). As to the supremacy clause, Standard asserts that there is Federal legislation applicable to Puerto Rico which preempts any State action that would undermine the purpose of the Federal legislation. Internal Revenue Code § 936 (26 USC § 936) provides a tax credit for taxable income received from sources outside the United States attributable to the conduct of a business within a United States possession. Standard maintains that Congress sought to induce investment in United States possessions by granting such favorable tax treatment and that New York's statute reduces this incentive; thus, the New York statute is at variance with the Federal legislation and is void. We perceive no such conflict. The power to tax is not conferred by the Federal Constitution but exists independently of it, and it has been well established that the historic police powers of the states were not to be superseded by a Federal act unless such was the clear and manifest purpose of Congress (*Ray* v *Atlantic Richfield Co.*, 435 US 151, 157; *Jones* v *Rath Packing Co.*, 430 US 519, 525; *Rice* v *Santa Fe Elevator Corp.*, 331 US 218, 230).

In dealing with cases involving the commerce clause as a challenge to State taxing powers, the Supreme Court has declared that a state tax is not unconstitutional per se when applied to interstate commerce and has sustained such taxes "when [they are] applied to an activity with a substantial nexus with the taxing State * * * [do] not discriminate against interstate commerce, and [are] fairly related to the services provided by the State" (*Complete Auto Transit* v *Brady*, 430 US 274, 279). In a similar vein, the Supreme Court has recognized that, despite the commerce clause, a state can properly require a corporation to file a combined report when the corporation and a foreign corporation were involved in a unitary business (*see, Container Corp. of Am.* v *Franchise Tax Bd.*, 463 US 159). Thus, the Supreme Court has recognized that a state's power to tax can coexist with a predominantly Federal power such as the regulation

of commerce. Internal Revenue Code § 936 was enacted in 1976 to continue a tax break for investments in Puerto Rico, but did so by providing a tax credit rather than the pre-1976 exclusion from income by which some companies were receiving a tax break for investment in foreign countries. While the purpose of the Federal statute is to stimulate investment in United States possessions, there is no indication anywhere of any policy for preemption of state franchise taxes with respect to companies with businesses in Puerto Rico. Since Standard has failed to demonstrate that the New York statute conflicts with the Federal legislation and that preemption was a " 'clear and manifest purpose of Congress' " (*Jones* v *Rath Packing Co., supra,* p 525, quoting *Rice* v *Santa Fe Elevator Corp.*, 331 US 218, 230), New York's power to require a combined report has not been superseded and there has been no denial of due process.

Standard further asserts that the apportionment of income to New York is unconstitutional and that the method of assessment imposed by the Department of Taxation and Finance does not accurately or properly reflect Caribbean's New York business. Both of these assertions are bottomed upon Standard's contention that Standard and Caribbean are not engaging in a unitary business. In view of our previous conclusion, that they are so engaged, no further comment on this issue is required.

Finally, Standard argues that the Department usurped a legislative function by, beginning in 1976, including income from possession corporations in the New York franchise tax base. This argument is specious. In 1976, the Federal law previously discussed changed the tax benefit from an exemption to a tax credit. Under New York law, New York net income is to be computed without deducting the amount of a tax credit permitted under Federal law (Tax Law § 208 [9] [b] [1]). Since the statute clearly provides for the inclusion of the amount of a tax credit, there was usurpation of a legislative function.

Opinion by MAIN, J., in which MAHONEY, P.J., MIKOLL, YESAWICH, JR., AND HARVEY, JJ. concur.

Determination confirmed, and petition dismissed, with costs.

At a Term of the Appellate Division of the Supreme Court of the State of New York, held in and for the Third Judicial Department, at the Justice Building, in the City of Albany, New York, commencing on the 16th day of December, 1985.

PRESENT:

HON. A. FRANKLIN MAHONEY,
Presiding Justice.

HON. ROBERT G. MAIN,
HON. ANN T. MIKOLL,
HON. PAUL J. YESAWICH, JR.,
HON. NORMAN L. HARVEY,
Associate Justices.

In the Matter of The Application of
STANDARD MANUFACTURING CO., INC.,

Petitioner,

For a Judgment under Article 78 of the Civil Practice Law and Rules

ORDER
50676

-against-

Albany County Clerk's Index No. 11207-84

TAX COMMISSION OF THE STATE OF NEW YORK and RODERICK G.W. CHU, FRANCIS R. KOENIG, and MARK FRIEDLANDER, acting as the Tax Commission of the State of New York,

Entered 2/3/86

Respondents.

The above-named petitioner having instituted this proceeding in Supreme Court, Albany County, pursuant to Article 78 of the Civil Practice Law and Rules, to review a determination of respondent State Tax Commission which sustained a franchise tax assessment imposed under Tax Law article 9-A, and said proceeding having been transferred for disposition to the Appellate Division, Third Department, by order of the Supreme Court at Special Term, dated October 26, 1984 and entered in Albany County, and having been presented during the above-stated Term of this Court and having

been argued by Anthony J. Amodeo, Jr., Esq., of counsel for petitioner and by Francis V. Dow, Assistant Attorney General, of counsel for respondents and after due deliberation, the Court having rendered a decision on the 30th day of January, 1986, it is hereby

ORDERED that the determination be, and the same hereby is, confirmed, and the petition is dismissed, with costs.

ENTER:

/s/ Michael J. Novak

Clerk

DATED AND ENTERED: February 3, 1986.

A TRUE COPY

Clerk

STATE OF NEW YORK
SUPREME COURT-ALBANY COUNTY

In the Matter of the Application of
STANDARD MANUFACTURING CO., INC.,

Petitioner,

For a Judgment under Article 78
of the Civil Practice Law and Rules

Judgment
Index No. 11207-84
DOL No. 84030464

-against-

TAX COMMISSION OF THE STATE OF NEW YORK and RODERICK G.W. CHU, FRANCIS R. KOENIG, and MARK FRIEDLANDER, acting as the Tax Commission of the State of New York,

Entered 2/5/86

Respondent.

The Petitioner herein, whose address is 750 Second Avenue, Troy, New York, 12182, having brought this proceeding pursuant to CPLR Article 78, to review a determination of Respondent State Tax Commission which sustained a franchise tax assessment imposed under Tax Law Article 9-A, said proceeding having been transferred to the Appellate Division - Third Department by order dated October 26, 1984 (Bradley, J.). and the Appellate Division - Third Department, after due deliberation, having rendered a decision on the 30th day of January 1986, ordering that the determination be confirmed, and the petition dismissed, with costs, and an order having been entered so affirming, it is hereby

ADJUDGED, that the aforesaid determination of the State Tax Commission be, and the same hereby is confirmed, and the petition dismissed, with costs of $162.50 to be taxed against the Petitioner, in favor of the Respondent, and that the Respondent have execution thereon.

DATED and ENTERED: 2/5/86

STATE OF NEW YORK
COUNTY OF ALBANY CLERK'S OFFICE ss.:

I, GUY D. PAQUIN, Clerk of the said County, and also Clerk of the Supreme and County Courts, being Courts of Record held therein, DO HEREBY CERTIFY that I have compared the annexed copy Judgment, with the original thereof filed in this office on the 5th day of February 1986 and that the same is a correct transcript therefrom, and of the whole of said original.

IN TESTIMONY WHEREOF, I have hereunto set my name and affixed my official seal, this 5th day of February 1986.

_____
Clerk

DECISION OF THE STATE TAX COMMISSION
DATED MAY 2, 1984

STATE OF NEW YORK
STATE TAX COMMISSION

In the Matter of the Petition
of
STANDARD MANUFACTURING CO., INC. DECISION

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended July 31, 1978 and July 31, 1979.

Petitioner, Standard Manufacturing Co., Inc., 750 Second Avenue, Troy, New York 12182, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended July 31, 1978 and July 31, 1979 (File No. 32654).

A formal hearing was held before Dennis M. Galliher, Hearing Officer, at the offices of the State Tax Commission, Building #9, State Office Campus, Albany, New York, on November 9, 1982 at 9:15 A.M., with all briefs to be submitted by March 3, 1983. Petitioner appeared by Lombardi, Reinhard, Walsh & Harrison, P.C. (Gary L. Lombardi, Esq. and Richard P. Walsh, Esq., of counsel). The Audit Division appeared by Paul B. Coburn, Esq. (Harry Kadish, Esq., of counsel).

ISSUE

Whether the Audit Division may properly require petitioner, Standard Manufacturing Co., Inc., and its subsidiary Caribbean Outerwear Corporation to file combined franchise tax reports for the fiscal years ended July 31, 1978 and July 31, 1979.

FINDINGS OF FACT

1. On December 10, 1980, the Audit Division issued to petitioner, Standard Manufacturing Co., Inc., separate notices of deficiency pertaining to each of the (petitioner's) fiscal years ended July 31, 1978 and July 31, 1979. These notices of deficiency asserted additional tax due of $92,810.33 for the fiscal year ended August 31, 1978, and $58,590.57 for the fiscal year ended August 31, 1979, plus interest for each year.

2. Separate statements of audit adjustment dated October 30, 1980, and pertaining to each of the above fiscal years, contained computations in explanation of the dollar amounts of additional tax asserted as due, as well as an explanation that the ". . .estimated deficiency is for failure to file a New York State franchise tax report, Form CT-3, for *Caribbean Outerwear Corp.* and to include such income on the combined report of Standard Manufacturing Co. . ."

3. Standard Manufacturing Co., Inc. ("Standard") was incorporated under the laws of New York State in December, 1960 and is engaged in the business of manufacturing highly-styled (fashionable) garments, worn for warmth and known as "outerwear". The board of directors of Standard is comprised of three individuals, George Arakelian, John Arakelian and Dorothy King, who also serve as president, vice-president and secretary-treasurer, respectively, of Standard. In addition, these three individuals own, in approximately

equal shares, all of the outstanding stock of Standard.

4. Caribbean Outerwear Corporation ("Caribbean") is a wholly-owned subsidiary of Standard, incorporated in 1968 under the laws of the State of Delaware. Caribbean's principal place of business is located in Jebuyoa, Puerto Rico. Caribbean is engaged in the manufacture of highly-styled outerwear, and also of "activewear", including garments such as tennis clothing and other sports outfits designed to be both fashionable as well as functional. The garments made by Caribbean differ from those made by Standard in that Caribbean's garments are more highly-styled. In addition, Standard makes no activewear.

5. Standard owns one hundred percent of the outstanding stock of Caribbean, and George Arakelian, John Arakelian and Dorothy King serve as Caribbean's board of directors and as its officers.

6. Caribbean's facilities are located in Puerto Rico because of the availability there of the skilled labor needed to manufacture the garments sold by Caribbean. At the time Caribbean was being set up to operate, Sixto Gonzalez was hired to be Caribbean's "chief operating officer" in Puerto Rico. Mr. Gonzalez did not become a member of Caribbean's board of directors, nor did he replace the previously-noted officers of Caribbean (*see* Finding of Fact "5").

7. Mr. Gonzalez earned a Bachelor of Science degree in Industrial Engineering from the University of Puerto Rico, School of Engineering. He also earned an Associate's Degree from the Fashion Institute of Technology in New York City, with course work emphasizing pattern making and design, and fabric analysis and grading, as well as the more traditional business/financial courses dealing predominantly with the particulars of the fashion industry. After completing his education, Mr. Gonzalez worked in various managerial capacities for several fashion and garment manufacturing concerns. Mr. Gonzalez was chosen by George Arakelian and hired by Caribbean because, in view of his education and experience, he was felt to be completely qualified to manage all aspects of Caribbean's operation.

8. Upon being hired by Caribbean, Mr. Gonzalez commenced making arrangements for the modifications necessary to transform a building purchased previously by Caribbean into a functional, operating, manufacturing facility. His actions in this regard included contracting for certain modifications to the layout of the building,

for electrical installations, and for equipment purchases. Mr. Gonzalez also was responsible for setting Caribbean's production lines, determining the number of clerical and production personnel necessary, hiring such personnel, setting hours worked, wages to be paid[1] vacation and holiday schedules, etc., and for handling relations between Caribbean and the Puerto Rican government. Finally, Mr. Gonzalez was responsible for establishing production levels and determining production costs, and was involved in the immediate and long-range planning and development of new merchandise, markets and customers for Caribbean. Several "department heads", including a plant manager, a cutting room manager and warehouse managers reported directly to Mr. Gonzalez.

9. Mr. Gonzalez approved invoices and authorized payment of bills by Caribbean. He also handled negotiations (often in conjunction with Caribbean's legal counsel) with Puerto Rican officials concerning environmental matters, OSHA and plant expansion. The most expensive machinery used by Caribbean costs approximately ten to fifteen thousand dollars and could be purchased by Mr. Gonzalez, if necessary, without first obtaining approval from Caribbean's Board of Directors. Mr. Gonzalez also purchased the raw materials used by Caribbean in manufacturing the garments.

10. Mr. Gonzalez was required to report annually to Caribbean's board of directors concerning the status of Caribbean's operations and the projection of costs for future products, orders and operations (manufacturing). Projects requiring large capital outlays, such as plant expansion (which has occurred during Caribbean's lifetime) would be discussed at this annual meeting and would require the approval of Caribbean's board of directors.

11. Caribbean maintained and paid the expenses of its sales office, showroom, sales personnel and designers located in Jebuyoa, Puerto Rico.

12. Standard did not train Caribbean's personnel, nor did it exchange personnel with or offer technical advice to Caribbean. There was no centralized warehousing of goods or raw materials nor any internal (intercompany) transfer of (raw) materials. Each company had its own separate accountants and legal counsel.

[1] Some of Caribbean's employees are salaried while others are paid on a piecework (units of production) basis.

13. Garments purchased by Standard from Caribbean were completed goods to which Standard did not add any finishing steps. Standard had other subsidiaries which manufactured goods different from those made by Caribbean. No business was conducted between Caribbean and Standard's other subsidiaries.

14. There were no intercorporate loans or other financing arrangements, as such, between Standard and Caribbean, and Caribbean had its own one million dollar line of credit with the Banco Popular de Puerto Rico.

15. Caribbean operated its manufacturing facilities only in Puerto Rico, and had no place of business, mailing address, telephone listing, bank accounts, inventory or supplies in New York State. Caribbean had no collection procedures in New York. Goods manufactured in Caribbean were shipped F.O.B. factory and title to the goods was passed to the buyer at the factory in Puerto Rico.

16. Caribbean's garments were manufactured based on either its own "prototype" designs which customers had ordered, or on samples sent by customers and modified by Caribbean to fit its machines and production capabilities. Materials need for manufacturing were purchased by Mr. Gonzalez in Puerto Rico and in the United States. Before a garment was manufactured in quantity, its price was determined by Mr. Gonzalez based on all direct and indirect costs involved in the manufacture of the garment, plus a markup amount for profit. This price was then subject to the customer's approval before an order was filled. No information was presented with regard to the markup amount or percentage for profit charged by Caribbean.

17. Caribbean maintained its bank account with the Banco Popular de Puerto Rico in Puerto Rico. All checks issued by Caribbean bore the signature of Dorothy King. Her signature was affixed by means of a check-signing machine, to which Mr. Gonzalez had access and through which he authorized and effected payment of Caribbean's bills. According to testimony, this check-signing procedure was employed in order to comply with a requirement under Puerto Rican law that only members of a corporation's board of directors could sign corporate checks in Puerto Rico.

18. George Arakelian testified that Caribbean was organized with the aim of generating a profit on its sales, and was not required to sell exclusively to Standard (or to any other entity). During the initial years of its operation, one hundred percent of Caribbean's

sales were made to Standard. During these initial years, Caribbean manufactured its garments according to the design specifications and in the quantities needed by Standard.

19. During the fiscal years at issue, approximately ninety percent of Caribbean's sales were made to Standard, while the remaining ten percent of its sales were made to various other customers. This change from selling exclusively to Standard occurred over a period of years during which time Caribbean and its products became known, and during which time Caribbean's manufactuirng facilities were expanded (*see* Finding of Fact "10").

20. Caribbean is listed in *The Industrial and Commercial Catalogue of Puerto Rico* and in the *Membership Directory: Puerto Rican Manufacturer's Association.* Mr. Gonzalez testified that these catalogues are the official directories listing all Puerto Rican manufacturers and suppliers, and their products and services, and that being listed in these catalogues is the "normal" manner by which companies (especially those in the garment manufacturing industry) in Puerto Rico "advertise" and make known their products and services. Caribbean did not otherwise advertise by publication, and has assertedly attracted some customers other than Standard through "word-of-mouth" advertising[2]

21. Standard did not determine or dictate the other customers to whom Caribbean sold, nor did Standard dictate the types of products made and sold by Caribbean to these customers. Standard asserts that all sales between it and Caribbean were made as "arm's length" transactions, and that at times Standard has refused to have certain goods manufactured by Caribbean because the cost of the goods, as projected by Mr. Gonzalez, was too high.

22. Standard asserts that an "agreement" between Standard, Caribbean and the Internal Revenue Service assures that transactions between Standard and Caribbean, with respect to the sale of goods, result in arm's length prices for the goods. However, this "agreement" consisted of a statement of (Internal Revenue Service) Income Tax Examination Changes wherein, *inter alia,* the price of goods from Caribbean to Standard during the fiscal years ended August 31, 1973, August 31, 1976 and August 31, 1977 were adjusted under Internal Revenue Code section 482 to reflect an arm's length price. No similar document or evidence of any agreement pertaining to the fiscal years at issue was offered by Standard.

[2]Mr. Gonzalez is listed under the title "manager" in both of the catalogues introduced as evidence.

23. Only approximately one to two percent of Caribbean's profits per year have been received by Standard, with all other profits remaining undistributed in Puerto Rico. This practice is maintained so that Caribbean may comply with the requirements and receive the benefits of Internal Revenue Code section 936 (Puerto Rico and Possession Tax Credit).

24. Standard and Caribbean did not file consolidated federal tax returns or consolidated financial statements during the fiscal years at issue.

25. The Audit Division and Standard have agreed, in the event the Commission finds Standard is required to file a combined franchise tax report including Caribbean, that the tax due shall be determined by a business allocation percentage (Tax Law §210.3), and that for the fiscal years at issue, the deficiencies shall be revised as follows:

FISCAL YEAR ENDED	DEFICIENCY
July 13, 1978	$11,599.63
July 31, 1979	16,003.22
Total	$27,602.85

CONCLUSIONS OF LAW

A. That subdivision 4 of section 211 of the Tax Law provides, in relevant part, as follows:

> "In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more corporations. . ., may be required or permitted to make a report on a combined basis covering any such other corporation. . .; provided, however, that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary, because of inter-company transactions, or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article. . ."

B. That regulations of the State Tax Commission in pertinent part provide:

"(a) . . .In deciding whether to permit or require combined reports the following two broad factors must be met:

(1) the corporations are in substance parts of a unitary business conducted by the entire group of corporations, and

(2) there are substantial intercorporate transactions among the corporations.

(b) In deciding whether each corporation is part of a unitary business, the Tax Commission will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

(1) manufacturing or acquiring goods or property for other corporations in the group; or

(2) selling goods acquired from other corporations in the group; or

(3) financing sales of other corporations of the group.

The Tax Commission will consider a corporation to be part of a unitary business if it is engaged in the same or related lines of business as the other corporations in the group, such as:

(4) manufacturing similar products; or

(5) performing similar services; or

(6) performing services for the same customers.

(c) In determining whether the substantial intercorporate transaction requirement is met, the Tax Commission will consider only transactions directly connected with the business conducted by the taxpayer, such as described in

paragraph (1), (2), or (3) of subdivision (b) of this section. Service functions such as accounting, legal, and personnel will not be considered. The substantial intercorporate transaction requirement may be met where as little as 50 percent of a corporation's receipts are from any qualified activities." (20 NYCRR 6-2.3)

C. That since Caribbean is a wholly-owned subsidiary of Standard, the stock ownership or control requirement of the statute (§211.4) is clearly met. Thus, a determination concerning whether or not combined filing is required rests upon a finding that Standard and Caribbean are in substance parts of a unitary business and that there are substantial intercorporate transactions between the two. Moreover, it must be determined whether "under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income [citation omitted]." *Matter Coleco Industries, Inc.* v. *State Tax Comm.*, 92 A.D.2d 1008, 1009, aff'd mem., 59 N.Y.2d 994.

D. That it is clear from the facts presented that there were substantial intercorporate transactions between petitioner and Caribbean, and that the two corporations were parts of the same unitary business. Both Standard and Caribbean were engaged in manufacturing and selling similar products, specifically clothing. While Standard manufactured no "activewear", both corporations manufactured "outerwear" differing only as to the degree of styling incorporated into the garments. During the years at issue, ninety percent (90%) of Caribbean's goods were manufactured for and sold to Standard, with Standard thereafter adding no further labor or styling to these goods before selling them. Notwithstanding the title and overall function of Mr. Gonzalez, ultimate control over Caribbean, and over Standard as the purchaser of ninety percent of Caribbean's output, rested with the three common officers and directors of Caribbean and Standard. Finally, while an amount or percentage was not specified, it is clear that the major portion of Caribbean's income (and hence its undistributed profits) was generated by its transactions with Standard.

E. That no details were given concerning the markup amount or profit percentage charged by Caribbean on its sales to Standard or to any of its other customers. The transactions between Standard

and Caribbean were alleged to have been at "arm's length" sales. However, the document introduced by Standard in support of this proposition (*see* Finding of Fact "22") pertains to years prior to those at issue, and reveals only that upon audit the Internal Revenue Service adjusted the pricing of goods sold by Caribben to Standard (in those prior years) to arrive at arm's length prices. There is thus no certainty that during the years at issue the prices paid were based upon arm's length bargaining or market factors. To the contrary, repeated Federal audit changes militate against the petitioner rather than support its claim of arm's length transactions, because those federal changes evidence a pattern of unrealistic pricing corrected only after audit. In view of the general corporate structure, the presence of distortion may thus be inferred as to any income or losses not specifically reviewed by Federal auditors. Accordingly, it was proper to require petitioner to include its subsidiary Caribbean on a combined franchise tax report.

F. That the petition of Standard Manufacturing Co., Inc. is hereby denied and the notices of deficiency dated December 10, 1980, as revised in accordance with Finding of Fact "25", together with such interest as may be lawfully owing, are sustained.

DATED: Albany, New York

MAY 02 1984

STATE TAX COMMISSION

_____

PRESIDENT

/s/ _____

COMMISSIONER

/s/ _____

COMMISSIONER

STATE OF NEW YORK
SUPREME COURT - ALBANY COUNTY

In the Matter of the Application of
Standard Manufacturing Co., Inc.,

Petitioner-Appellant,DOL No.
84030464

For a Review of a Judgment under Article
78 of the Civil Practice Law and Rules,

INDEX No.
11207-84

-against-

TAX COMMISSION OF THE STATE OF NEW YORK
and RODERICK G. W. CHU, FRANCIS R. KOENIG
and MARK FRIEDLANDER, acting as the Tax
Commission of the State of New York,

Respondents.

The Petitioner-Appellant herein, whose address is 750 Second Avenue, North Troy, New York, 12182, having appealed to the Court of Appeals of the State of New York from an order of the Appellate Division-Third Department entered February 3, 1986, which confirmed a determination of the State Tax Commission which sustained a franchise tax assessment imposed under Tax Law Article 9-A, and dismissed the petition herein, and the Court of Appeals, after due deliberation, having rendered a decision on the 16th day of December, 1986, ordering that the judgment so appealed from be affirmed, with costs, the Remittitur from the Court of Appeals having been filed in the office of the Clerk of the County of Albany, it is hereby

ADJUDGED, that the aforesaid order of the Appellate Division-Third Department be, and the same hereby is affirmed, with costs of $190.00 to be taxed against the Petitioner-Appellant, in favor of Respondents, and that the Respondents have execution thereon.

/s/ _____
DEPUTY COUNTY CLERK

DATED AND ENTERED:
12-30-86

NEW YORK STATE COURT OF APPEALS TO THE UNITED STATES SUPREME COURT

STANDARD MANUFACTURING CO., INC.,

Petitioner-Appellant,

-against-

TAX COMMISSION OF THE STATE OF NEW YORK and RODERICK G. W. CHU, FRANCIS R. KOENIG and MARK FRIEDLANDER, acting as the Tax Commission of the State of New York,

NOTICE OF APPEAL

(#11207-84)
Albany County

Respondents.

The party taking the appeal is Standard Manufacturing Co., Inc.

Appellant seeks to appeal a judgment of the New York State Court of Appeals entered on December 16, 1986, which determined that New York State Tax Law, Section 211 (4), was not in conflict with the 26 United States Code Section 936.

This appeal is taken under the authority of:

28 USCA 1257(2), (3).

Michael T. McGarry
LOMBARDI, REINHARD,
WALSH & HARRISON, P.C.
Attorneys for Appellant
5 Computer Drive West
Albany, New York 12205
Telephone: (518) 438-2000

RECEIVED
MAR - 4 1987
COURT OF APPEALS

AFFIDAVIT OF PERSONAL SERVICE

Michael T. McGarry, being duly sworn, deposes and says that I am over the age of eighteen years; that I personally served the within Notice of Appeal upon the following attorney at the following time and place in the following manner; March 4, 1987 to Robert Abrams, Attorney, General, C/O James D. Cole, Associate Attorney, Department of Law, attorneys for the New York State Tax Commission, The Capitol, Albany, New York.

That I further personally served a copy of the within Notice of Appeal upon the County Clerk, Albany County of the State of New York for filing thereon on the 4th day of March at the County Courthouse in Albany, New York upon County Clerk's Office.

/s/ _____
Michael T. McGarry

Sworn to before me this 4th day
of March, 1987.

/s/ _____
Notary Public

PATRICIA BRYCE
Notary Public, State of New York
Qualified in Albany County
No. 4811604
Commission Expires 7/31/88

RECEIVED
MAR - 4 1987
COURT OF APPEALS

§ 931. Income from sources within possessions of the United States

(a) General rule.—In the case of individual citizens of the United States, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) 3-year period.—If 80 percent or more of the gross income of such citizen (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) Trade or business.—If 50 percent or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Amounts received in United States.—Notwithstanding subsection (a), there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) Definition.—For purposes of this section, the term "possession of the United States does not include the Commonwealth of Puerto Rico, the Virgin Islands of the United States, or Guam.

(d) Deductions.—

(1) General Rule.—Except as otherwise provided in this subsection and subsection (e), in the case of a citizen of the United States entitled to the benefits of this section the deductions shall be allowed only if and to the extent that they are connected with income from sources within the

United States, and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary.

(2) **Exceptions,**—The following deductions shall be allowed whether or not they are connected with income from sources within the United States:

(A)The deduction, for losses not connected with the trade or busines if incurred in transactions entered into for profit, allowed by section 165(c)(2), but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

(B)The deduction, for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165(c)(3), but only if the loss is of property within the United States.

(C)The deduction for charitable contributions and gifts allowed by section 170.

(e) **Deduction for personal exemption.**—A citizen of the United States entitled to the benefits of this section shall be allowed a deduction for only one exemption under section 151.

(f) **Allowance of deduction and credits.**—A citizen of the United States entitled to the benefits of this section shall receive the benefit of the deduction and credits allowed to them in this subtitle only by filing or causing to be filed with the Secretary a true and accurate return of their total income received from all sources in the United States, in the manner, prescribed in subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits.

(g) **Foreign tax credit.**—Persons entitled to the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(h) Employees of the United States.—For purposes of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

(Aug. 16, 1954, c. 736, 68A Stat. 291; No. 13, 1966, Pub.L. 89-809, Title I, § 103 (a), 80 Stat. 1571; Dec. 10, 1971, Pub.L. 92-178, Title V, § 502(d), 85 Stat. 550, Oct. 31, 1972, Pub.L. 92-606 § 1(f)(1), 86 Stat. 1497; Oct. 4, 1976, Pub.L. 94-455, Title X, § 1051(c), Title XIX, §§ 1901(a)(117), 1906(b)(13)(A), 90 Stat. 1645, 1764, 1834; May 23, 1977, Pub.L. 95-30, Title 1, § 101(d)(12), 91 Stat. 134.)

§936. Puerto Rico and possession tax credit

(a) Allowance of credit.—

(1) In general.—Except as provided in paragraph (3), if a domestic corporation elects the application of this section and if the conditions of both subparagraph (A) and subparagraph (B) of paragraph (2) are satisfied, there shall be allowed as a credit against the tax imposed by this chapter an amount equal to the portion of the tax which is attributable to the sum of—

(A) the taxable income, from sources without the United States, from—

(i) the active conduct of a trade or business within a possession of the United States, or

(ii) the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business, and

(B) the qualified possession source investment income.

(2) Conditions which must be satisfied.—The conditions referred to in paragraph (1) are:

(A) **3-year period.**—If 80 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States (determined without regard to section 904(f)); and

(B) **Trade or business.**—If 50 percent or more of the gross income of such domestic corporation for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States.

(3) **Credit not allowed against certain taxes.**—The credit provided by paragraph (1) shall not be allowed against the tax imposed by—

(A) section 56 (relating to minimum tax),

(B) section 531 (relating to the tax on accumulated earnings),

(C) section 541 (relating to personal holding company tax), or

[(D) Repealed. Pub.L. 94-455, Title XIX, § 1901(b)(37)(B), Oct 4, 1976, 90 Stat. 1803]

(E) section 1351 (relating to recoveries of foreign expropriation losses).

(b) Amounts received in United States.—In determining taxable income for purposes of subsection (a), there shall not be taken into account as income from sources without the United States any gross income which was received by such domestic corporation within the United States, whether derived from sources within or without the United States.

(c) Treatment of certain foreign taxes.—For purposes of this title, any tax of a foreign country or a possession of the United States which is paid or accrued with respect to taxable income which is taken into account in computing the credit under subsection (a) shall not be treated as income, or profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amounts so paid or accrued.

(d) Definitions and special rules.—For purposes of this section—

(1) Possession.—The term "possession of the United States" includes the Commonwealth of Puerto Rico, but does not include the Virgin Islands of the United States.

(2) Qualified possession source investment income.—The term "qualified possession source investment income" means gross income which—

(A) is from sources within a possession of the United States in which a trade or business is actively conducted, and

(B) the taxpayer establishes to the satisfaction of the Secretary is attributable to the investment in such possession (for use therein) of funds derived from the active conduct of a trade or business in such possession, or from such investment,

less the deductions properly apportioned or allocated thereto.

(3) Carryover basis property.—

(A) In general.—Income from the sale or exchange of any asset the basis of which is determined in whole or in part by reference to its basis in the hands of another person shall not be treated as income described in subparagraph (A) or (B) of subsection (a)(1).

(B) **Exception for possessions corporations, etc.**—For purposes of subparagraph (A), the holding of any asset by another person shall not be taken into account if throughout the period for which such asset was held by such person section 931, this section, or section 957(c) applied to such person.

(e) Election.—

(1) **Period of election.**—The election provided in subsection (a) shall be made at such time and in such manner as the Secretary may by regulations prescribe. Any such election shall apply to the first taxable year for which such election was made and for which the domestic corporation satisfied the conditions of subparagraph (A) and (B) of subsection (a)(1) and for each taxable year thereafter until such election is revoked by the domestic corporation under paragraph (2). If any such election is revoked by the domestic corporation under paragraph (2), such domestic corporation may make a subsequent election under subsection (a) for any taxable year thereafter for which such domestic corporation satisfies the conditions of subparagraphs (A) and (B) of subsection (a)(1) and any such domestic corporation under paragraph (2).

(2) **Revocation.**—An election under subsection (a)—

(A) may be revoked for any taxable year beginning before the expiration of the 9th taxable year following the taxable year for which such election first applies only with the consent of the Secretary; and

(B) may be revoked for any taxable year beginning after the expiration of such 9th taxable year without the consent of the Secretary.

(f) DISC or former DISC corporation ineligible for credit.—No credit shall be allowed under this section to a corporation for a taxable year for which it is a DISC or former DISC (as defined in section 992(a)) or in which it owns at any time stock in a DISC or former DISC.

(g) Exception to accumulated earnings tax.—

(1) For purposes of section 535, the term "accumulated taxable income" shall not include taxable income entitled to the credit under subsection (a).

(2) For purposes of section 537, the term "reasonable needs of the business" includes assets which produce income eligible for the credit under subsection (a).

4. In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such information as the tax commission may require; provided, however, that any corporation which owns or controls either directly or indirectly substantially all the capital stock of a DISC not exempt from tax under paragraph (i) of subdivision nine of section two hundred eight of this article shall be allowed, at the election of such corporation, to make a report on a combined basis covering such DISC, but the failure of such corporation to make such election shall not prohibit the tax commission from requiring a combined report covering such corporation and such DISC; provided, further, that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order to properly reflect the tax liability under this article. In the case of a combined report the tax shall be measured by the combined entire net income or combined capital, of all the corporations included in the report. In computing combined entire net income intercorporate dividends shall be eliminated, in com-

puting combined business and investment capital intercorporate stockholdings and intercorporate bills, notes and accounts receiveable and payable and other combined intercorporate indebtedness shall be eliminated and in computing combined subsidiary capital intercorporate stockholdings shall be eliminated, provided, however, that intercorporate dividends from a DISC or a former DISC not exempt from tax under paragaph (i) of subdivision nine of section two hundred eight of this article which are taxable as business income under this article shall not be eliminated.

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Respectfully Submitted

Martin Weinstein

Supreme Court, U.S.
FILED
APR 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1518

IN THE

Supreme Court of the United States

October Term, 1986

STANDARD MANUFACTURING CO., INC.,
Appellant,

against

TAX COMMISSION OF THE STATE OF NEW YORK and RODERICK G.W. CHU, FRANCIS R. KOENIG and MARK FRIEDLANDER, acting as the Tax Commission of the State of New York,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK.

MOTION TO DISMISS OR AFFIRM

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FRANCIS V. DOW
Assistant Attorney General of Counsel

Dated: April 14, 1987

12pp

Question Presented.

Whether the provisions of New York State Tax Law §211(4) by requiring New York parent corporation to file a combined franchise tax report with its subsidiary, which conducts business in Puerto Rico, in order to reflect New York tax liability properly, violate the Supremacy, Due Process and Equal Protection Clauses of the United States Constitution.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986.

No. 86-1518

STANDARD MANUFACTURING CO., INC.,

Appellant,

against

TAX COMMISSION OF THE STATE OF NEW YORK and RODERICK G. W. CHU, FRANCIS R. KOENIG and MARK FRIEDLANDER, acting as the Tax Commission of the State of New York,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK.

MOTION TO DISMISS OR AFFIRM

The appellees move the Court to dismiss the appeal or, in the alternative, to affirm the judgment of the Court of Appeals of the State of New York on the ground that it is manifest that no substantial Federal question is raised by the appeal.

State Statute Involved

Under New York Tax Law, § 211(4) and the regulations promulgated under its provisions, the New York State Tax Commission is authorized to require a corporation to file a tax report on a combined basis with another corporation where it appears that: a corporate taxpayer owns all the capital stock of the other corporation; such report is deemed necessary, because of intercompany transactions of the corporations, to reflect properly tax liability under Tax Law Article 9-A; and each corporation required to be included in the combined report is in substance part of a unitary business conducted by the group. In such a tax report, the combined entire net income of the corporations are reported, allocated within and without New York under a three-factor formula, and the New York allocated income forms the base on which New York tax liability is computed. New York Tax Law, § 210(3).

Statement of Facts

The appellant, Standard Manufacturing Co., Inc. (Standard), is a New York corporation with its principal place of business in New York and is engaged in the manufacture, purchase and sale of clothing. It wholly owns Caribbean Outwear Corporation (Caribbean) which is a Delaware corporation that has its principal place of business in Jabuyoa, Puerto Rico. Caribbean manufactures and sells "activewear" clothing designed for wear by persons engaged in somewhat strenuous physical exercise. During the years in issue, fiscal years ended July 31, 1978 and July 31, 1979, Caribbean sold 90% of its products to Standard, Caribbean's advertising was minimal, consisting of two listings in local directories and little effort was made to sell its products to anyone else.

The appellees, New York State Tax Commission, following an administrative hearing, sustained a tax deficiency issued to Standard for the years in issue which resulted from requiring Standard to file combined corporate franchise tax returns with Caribbean in order to reflect New York corporate franchise tax liability properly. Standard at the administrative hearing contended that it had adjusted its prices to reflect arms length pricing with Caribbean as a result of an agreement made with the United States Internal Revenue Service and that, as a result, Caribbean's income was not distorted. The agreement was reached after a tax audit was conducted by the Internal Revenue Service of Standard and Caribbean for years prior to the years in issue here. The New York Tax Commission found that repeated changes as a result of Federal audits evidenced a pattern of unrealistic pricing between Standard and Caribbean which were corrected only after audit and that the presence of distortion may be inferred as to income or losses not specifically reviewed by Federal auditors (Petr Jur State 25, 29).

The New York Supreme Court, Appellate Division, Third Department, in its unanimous decision (114 N. Y. A. D. 2d 138), found that there was sufficient evidence to support the Tax Commission determination. On December 16, 1986, the Court of Appeals of the State of New York summarily affirmed the judgment of the Appellate Division for the reasons stated in that court (69 N. Y. 2d 635 [1987]).

ARGUMENT

The appellant does not raise a substantial Federal question.

The appellant's contentions that New York is preempted from requiring the inclusion of income of Caribbean with

that of Standard in a combined report by the provisions of Internal Revenue Code, § 936, and that it is in violation of the Supremacy Clause of the United States Constitution (U. S. Const., art VI, § 2) are manifestly unsubstantial. A state's taxing power is not conferred by the Federal Constitution but exists independently of it. *People ex rel. Hatch v. Reardon,* 184 N. Y. 431 (1906), *affd.,* 204 U. S. 152 (1907). It has long been recognized that "historic * * * powers of the States [are] not to be superseded" by Federal law, "unless that was the clear and manifest purpose of Congress". *Rice v. Santa Fe Elevator Corp.,* 331 U. S. 218, 230 (1947). *Accord, e.g., Ray v. Atlantic Richfield Co.,* 435 U. S. 151, 157 (1978). There is no constitutional prohibition which prevents states from requiring corporations to file combined reports with foreign or alien corporations which are engaged in a unitary business within and without the several States. *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983).

Under New York Tax Law, § 211(4), the Tax Commission may require the filing of a combined tax report only where it deems such a report necessary "in order properly to reflect tax liability" under Tax Law, Article 9-A. In taxing corporations doing business in New York, extraterritorial values cannot be taxed by the State even in the absence of a Federal statute preventing it from doing so. New York, in taxing corporations doing business within New York and outside of New York, either separately or on a combined basis, uses a three-factor formula in order to allocate income of corporations to New York. Standard claims that New York is taxing income earned by Caribbean in Puerto Rico, but it did not show that anything more than allocated New York income is being reached by requiring Standard to file a combined report with Caribbean.

Congress, prior to the enactment of Tax Reform Act of 1976, P.L. 94-455, did not prohibit the States from taxing income of corporations allocable to them by excluding from Federal taxation income claimed to have been earned by certain qualified corporations in Puerto Rico. Nor did it do so thereafter by granting such qualified corporations tax credits against their United States taxes. New York, by taxing income of a New York corporation not shown to have been earned by a subsidiary in Puerto Rico, does not frustrate the congressional intent to encourage investments in Puerto Rico by Federal tax incentives.

Standard has pointed to no statute, court decision or congressional history which shows that Congress intended to preempt States from requiring a corporation doing business in the taxing State from including in a combined report a corporation doing business in Puerto Rico, with the purpose of imposing taxes solely on income which is properly allocable to the taxing State. Without a showing that extraterritorial values are being taxed, Standard's claim that New York has been preempted from requiring it to file a combined report with Caribbean is simply without merit and presents no substantial Federal question.

The inclusion of Caribbean in a combined report which does not result in reaching income other than that which is the proper and accurate reflection of income earned in New York does not violate the Due Process Clause of the United States Constitution. No showing has been made that the taxes imposed on Standard is in violation of the tests for valid state taxes announced in *Complete Auto Transit v. Brady,* 430 U. S. 274, 279 (1977). Nor has appellant claimed that other taxpayers similarly situated are not subject to the provisions of New York Tax Law, § 211(4).

The appellant's claim that the New York State Tax Commission required Standard to file a combined tax re-

port with Caribbean beginning in 1976 resulted only from the change in the form of the tax benefit provisions in the internal revenue code is without support and has no relevance. The fact that the State Tax Commission did not require Standard to file such a combined report for previous years did not prevent the Tax Commission from requiring proper compliance with the New York Tax Law for the years in issue. As pointed out in the decision of the New York Supreme Court, Appellate Division, there was no usurpation of a legislative function by the Tax Commission here, a claim that included petitioner's argument below. New York Tax Law, § 211(4) clearly authorized the Tax Commission to require the filing of combined reports long before the years in issue in order to reflect tax liability properly.

CONCLUSION

Appellee submits that the question upon which this case depends is so unsubstantial as not to need further argument, and appellee moves the Court to dismiss this appeal, or, in the alternative, to affirm the judgment entered in the case by the Court of Appeals of the State of New York.

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Respectfully submitted,

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